United States Court of Appeals

for the Second Circuit

PETITION FOR REHEARING EN BANC

74-1969-2366-2341

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United States Court of Appeals

FOR THE SECOND CIRCUIT

IIT, an International Investment Trust, and GEORGES BADEN, JACQUES DELVAUX and ERNEST LECUIT, as Liquidators for IIT, an International Investment Trust,

Plaintiffs-Appellees-Cross-Appellants,

—against—

VENCAP, LTD., INTERVENT, INC., INTERCAPITAL, N.V., RICHARD C. PISTELL, CHARLES E. MURPHY, JR., DAVID TAYLOR and HAVENS, WANDLESS, STITT & TIGHE,

Defendants-Appellants-Cross-Appellees,

and

WALTER BLACKMAN, ROBERT L. VESCO, MILTON F. MEISSNER, NORMAN LeBLANC and STANLEY GRAZE,

Defendants.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

PETITION FOR REHEARING AND SUGGESTION FOR REHEARING IN BANC

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UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

Docket Nos. 74-1969, 74-2366, 74-2341

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PETITION FOR REHEARING

SUGGESTION FOR REHEARING IN BANC

To The Honorable Judges of the United States Court of Appeals for the Second Circuit

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Introduction

IIT, an International Investment Trust ("IIT"), and Georges Baden, Jacques Delvaux and Ernest Lecuit as Liquidators of IIT ("Liquidators"), hereafter sometimes referred to collectively as "plaintiffs", (i) respectfully petition this Court pursuant to Rule 40 of the Federal Rules of Appellate Procedure for rehearing of the appeal in this case decided April 28, 1975, and (ii) respectfully suggest rehearing in banc pursuant to Rule 35 of the Federal Rules of Appellate Procedure.

The Decision

On April 28, 1975 a panel (Circuit Judges Friendly, Mulligan and Timbers) of this Court (a) directed the District Court below to take further proceedings consistent with the opinion of this Court (per Judge Friendly), (b) retained jurisdiction, (c) directed that, pending such further proceedings, the preliminary injunction previously issued by the court below remain in effect, and (d) dismissed plaintiffs' cross-appeal from the order below that allowed defendant Vencap, Ltd. ("Vencap") to expend $40,000.

The basic decision of this Court was summarized at page 3192 of its slip opinion (hereafter "Sl. Op., p. ____"), that the "findings" of the court below "required by Fed. R. Civ. P. 52(a), are not sufficient to enable us to make a definitive determination on the issue of subject matter jurisdiction or, if that bridge can be crossed, on the question whether plaintiffs showed a sufficient probability of success on the merits to warrant its order issuing a temporary injunction and appointing a receiver, from which

defendants appeal." See also Sl. Op., p. 3223.

Rehearing and Rehearing In Banc

Plaintiffs respectfully suggest that the opinion of this Court evidences "points of law" and "fact" that have been "overlooked" and "misapprehended" (Rule 40, Fed. R. App. P.) so as to warrant the grant of a rehearing. Plaintiffs further suggest that rehearing in banc is appropriate because these proceedings involve questions of exceptional importance (Rule 35, Fed. R. App. P.), and the opinion of Judge Friendly reaches results plainly inconsistent with decisions of the United States Supreme Court. Finally, plaintiffs submit that the Court should grant rehearing in banc in order to secure and maintain uniformity of decisions in this Circuit.

Reasons for Granting Rehearing

The opinion of this Court (a) will have widespread impact in connection with security frauds, especially in the future determination of jurisdiction of federal courts over securities frauds that involve activities of United States citizens and events occurring both within and without the United States, (b) establishes new standards that limit the applicability of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, and (c) imposes an unreasonable burden of proof for establishing both United States jurisdiction over, and the very existence of, violations of Rule 10b-5 in transnational securities frauds.*

* At page 3220, the Court, after ruling on jurisdiction based upon "perpetration of fraudulent acts" as opposed to "preparatory activities or the failure to prevent fraudulent acts", stated that "Admittedly the distinction is a fine one." Fine distinctions on underlying jurisdictional matters strongly suggest the need for in-depth consideration in banc of the principles of law being expounded, particularly since numerous IOS related litigations presently are pending in the Southern District of New York. See also pending appeal in SEC v. Vesco, et al., 72 Civ. 5001, Docket No. 73-8441.

1. The Opinion Conflicts with Decisions of the United States Supreme Court

In Superintendent of Insurance v. Bankers Life & Cas. Co., 404 U.S. 6 (1971), the Supreme Court ruled that misappropriation of the proceeds of an otherwise normal and bona fide securities transaction was not separate from that transaction and brought the entire scheme within the coverage of Rule 10b-5. As in Superintendent of Insurance, the defendant Pistell accomplished substantial misuse, personal use, and misappropriation of funds in New York, having obtained the funds from the sale of securities to plaintiff IIT. The connection between the sale of securities and the misappropriation in the case at bar is the same as it was in Superintendent of Insurance. Accordingly, this Court should have affirmed subject matter jurisdiction as a matter of law since the Pistell misappropriations were found to have occurred in New York, and they are the basis for bringing within Rule 10b-5 each and every aspect of the transaction. *

Furthermore, the Court's formulation of the law of subject matter jurisdiction gives inadequate weight to the importance of acts committed in the United States which are not per se violations of the law, but which constitute integral and necessary parts of an overall scheme to defraud. The opinion states at p. 3220:

* In Securities and Exchange Commission v. Manor Nursing Centers, Inc., 458 F.2d 1082, 1094-95 (2d Cir. 1972), this Court held that Superintendent of Insurance governed the failure of the issuer, its principal, underwriters and attorney and selling shareholders to return to the investing public the proceeds of an "all or nothing" offering after it had become clear to all concerned that a substantial part of the offering had not been sold. The Court found explicitly that the misappropriation of the proceeds of the offering constituted a violation of the anti-fraud provisions of the federal securities laws (id. at 1094).

"Our ruling on this basis of jurisdiction is limited to the perpetration of fraudulent acts themselves and does not extend to mere preparatory activities or the failure to prevent fraudulent acts where the bulk of the activity was performed in foreign countries, such as in Bersch."

Such a ruling as this Court made is inconsistent with Steele v. Bulova Watch Co., Inc., 344 U.S. 280, 289 (1952). In Steele the Court held that, when it is not possible to interfere with the sovereignty of another nation, the District Court may in exercising its equity powers command persons to cease or perform acts outside its territorial jurisdiction if in personam jurisdiction is present. More importantly, in Steele the Court also recognized that it is improper to isolate parts of an overall scheme (344 U.S. at 287):

"We do not deem material that petitioner affixed the mark 'Bulova' in Mexico City rather than here, or that his purchases in the United States when viewed in isolation do not violate any of our laws. They were essential steps in the course of business consummated abroad; acts in themselves legal lose that character when they become part of an unlawful scheme." (footnote omitted)

The opinion also appears to be returning to the principle of caveat emptor for certain investors in its conclusion that theory (1) is "exceedingly weak on the merits". The effect is the imposition of a new and subjec-

tive disclosure standard based upon the sophistication of the parties and the experience of assisting counsel. The opinion provided two standards for full disclosure -- one for the "unsophisticated" and unsuspecting public and the other for investors who are sophisticated and/or assisted by experienced counsel (see Sl. Op., pp. 3206, 3209).

Thus, caveat emptor would appear to be the Court's standard for "sophisticated investors", contrary to the spirit of full disclosure enunciated by the Supreme Court in Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1971):

> "The Court has said that the 1934 Act and its companion legislative enactments embrace a 'fundamental purpose . . . to substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the securities industry.' SEC v. Capital Gains Research Bureau, 375 U.S. 180, 186 (1963)." (footnote omitted)

The Court found that a sophisticated investor advised by experienced counsel would not have been misled by the three-page memorandum addressed to plaintiff IIT by Vencap because it

> ". . . describe[d] exactly what the preferential capital investors would get, even to the point of annexing a copy of the Vencap shareholder resolution defining the rights and privileges of the preferred stock." Sl. Op., p. 3207.

The opinion overlooks the fact that the memorandum purports on page three to set forth an "outline" of the rights of the preferential shares as more fully described in the "annexed"* shareholder resolution, but proceeds to omit any mention of Vencap's right to redeem the shares at par value at any time with payment of a 6% dividend, if any, accrued from the first day of

* There is nothing in the record to indicate that the shareholder resolution was ever in fact annexed to the three-page memorandum.

the calendar year of the redemption. The redemption right, of course, is the key to the basic sham nature of the investment, since it would permit Vencap to accumulate earnings and then redeem the preferential shares instead of making a distribution of the earnings. The Supreme Court's construction of the securities laws does not immunize the stating of a material falsehood in one document because the truth is stated elsewhere.

2. The Opinion Conflicts with Decisions of this Court

The conflict of the opinion with decisions of this Circuit is particularly apparent in regard to its holdings on subject matter jurisdiction over transnational securities frauds. The effect of this conflict could be to create subject matter jurisdiction confusion, or even chaos, in the administration and enforcement of the securities laws of the United States when frauds crossing national borders are involved.*

The opinion goes to extensive lengths to minimize effects upon the 300 American fundholders of IIT as a basis for subject matter jurisdiction (see Sl. Op., pp. 3216-18). This approach is contrary to Schoenbaum v. Firstbrook, 405 F.2d 200 (2d Cir.), rev'd in part on other grounds, 405 F.2d 215 (2d Cir. 1968) (en banc), cert. denied, sub nom., Manley v. Schoenbaum, 395 U.S. 906 (1969).

Schoenbaum stands for the proposition that federal courts have subject matter jurisdiction to adjudicate actions predicated upon fraudulent acts which occurred without the United States but which had a detrimental

* The Securities and Exchange Commission submitted an amicus curiae brief in support of plaintiffs' position to this Court, but this Court seemingly failed to give any weight to the views of the federal agency charged with administering and enforcing the securities laws.

effect upon American investors and the American investing milieu. This Court's opinion adopts a de minimus test not called for under Schoenbaum, but even the novel de minimis test should be more than met when it is considered that 300 Americans are involved as investors and a $3,000,000 "investment" was made.

In Leasco Data Processing Equipment Corp. v. Maxwell, 468 F.2d 1326 (2d Cir. 1972), this Court held that substantial fraudulent misrepresentations within the United States were sufficient to confer subject matter jurisdiction on federal courts for Rule 10b-5 actions. Under Superintendent of Insurance, supra, Pistell's misuse and misappropriation of the proceeds of the securities sale were fraudulent as a matter of law and, therefore, the opinion of this Court is in conflict with Leasco.*

The restrictive reading of the jurisdictional scope of the securities laws in this Court's opinion is contrary to the reasoning of Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 235 (2d Cir. 1974):

* The opinion is also in direct conflict with decisions in the Eighth and Ninth Circuits. In Travis v. Anthes Imperial Limited, 473 F.2d 515, 526-7 (8th Cir. 1973), the Court rejected fragmenting by tieing jurisdiction to United States acts in the "final stage" of the "scheme" even though the "objectionable conduct" had occurred earlier in Canada and was known at such "final stage". In SEC v. United Financial Group, Inc., 474 F.2d 354, 356-7 (9th Cir. 1973), the Court was dealing with only three American shareholders but refused to be persuaded by an argument premised upon de minimus numbers: "The relative number of American citizen shareholders [three] vis-a-vis alien shareholders is not determinative of whether United States courts may assert jurisdiction. . . . Since the securities laws have always been construed very broadly to promote the remedial purposes behind them, we find unpersuasive the argument that jurisdiction should be declined because only a very few instances of sales to American citizens have been shown, especially given the practical difficulties present in this case. 'That the jurisdiction hook need not be large to fish for securities law violations is well established.' Lawrence v. SEC, 398 F.2d 276, 278 (1st Cir. 1968)."

"Moreover, in applying the anti-fraud provisions of the securities laws to the facts of this case, it is important to bear in mind that 'Congress intended securities legislation enacted for the purpose of avoiding frauds to be construed "not technically and restrictively, but flexibly to effectuate its remedial purposes."' * * * This policy of flexible, non-technical construction of the securities laws has provided the underpinning for the results in recent cases involving specific violations of the anti-fraud provisions of the securities laws. E.g., Superintendent of Insurance v. Bankers Life & Casualty Co., 404 U.S. 6, 12 (1971); SEC v. Glen-Arden Commodities, Inc., 493 F.2d 1027, 1033-34 (2d Cir. 1974); International Controls Corp. v. Vesco, 490 F.2d 1334, 1345 (2d Cir. 1974)."

The opinion is especially in conflict with the Congressional purpose of avoiding frauds as stated in Shapiro when this Court applied jurisdiction only to "perpetration" or "consummated fraud" and not to either "preparation" or "failure to prevent" (Sl. Op., p. 3220):

"Our ruling on this basis of jurisdiction is limited to the perpetration of fraudulent acts themselves and does not extend to mere preparatory activities or the failure to prevent fraudulent acts where the bulk of the activity was performed in foreign countries, such as in Bersch."

3. This Court Incorrectly Rejected Plaintiffs' Argument that Congress must have Intended to Protect the American Securities Industry from the Adverse Effects upon it of Massive Frauds upon Foreign Citizens Perpetrated by United States Citizens in the Sale of Securities of American Corporations

In its opinion in this case, this Court did not address itself to IIT's argument that massive frauds of this character perpetrated upon foreign nationals by United States citizens in the sale of American securities are of such a direct and devastating impact on the United States securities market so as to compel the conclusion that Congress intended to proscribe them.*

* This Court dealt at great length with this issue in its decision in Bersch v. Drexel Firestone, Inc., decided on April 28, 1975, Sl. Op., pp. 3137-87.

The enormity of the fraud, regardless which theory is ultimately determined by the jury to have been proven, exemplified the disrepute that such conduct causes for the American securities market and the severe long-standing adverse economic consequences flowing from it. Accordingly, we submit that this Court was too restrictive in this case and in Bersch in its analysis of Congressional intent. Moreover, this is an issue of such exceptional importance that in the public interest the entire Court should decide it in banc, particularly in view of this Court's recognition that:

> ". . . reasonable men might conclude that the coverage was greater, or less, than has been outlined in this opinion and in IIT v. Vencap, Ltd., this day decided. Our conclusions rest on case law and commentary concerning the application of the securities laws and other statutes to situations with foreign elements and on our best judgment as to what Congress would have wished if these problems had occurred to it." Bersch, supra, Sl. Op., p. 3171.

4. This Court Overlooked the Fact that the District Court had made Findings that Satisfy this Court's Criteria for Subject Matter Jurisdiction

In analyzing the opinion of the District Court, this Court focused on Judge Stewart's findings to the effect that the three-page memorandum contained false and misleading statements, which the Court denominates as theory (1) (Sl. Op., pp. 3206, 3220). Since this Court concluded that the preparation and use of the three-page memorandum did not involve any "significant activity" within the United States, it held that there is no subject matter jurisdiction under this theory, ibid. This Court also observed that this theory was "exceedingly weak on the merits" (Sl. Op., p. 3207).

This Court overlooked the fact that Judge Stewart also emphasized in his findings the omission from the three-page memorandum of any mention of Pistell's intention to use a substantial portion of IIT's investment for his

personal use and for the benefit of companies in which he had an interest. The District Court's findings in this regard, appearing under the heading "Conclusions of Law", are as follows:

> "In light of the circumstances, unless one infers a conspiracy in which case IIT knew everything that Pistell knew, [footnote omitted] there were also substantial and material omissions from the three-page memorandum. The three-page memorandum failed to disclose that the preference shareholders could receive only one-third of the net gain of Vencap and then only at the pleasure of the holders of the ordinary shares, Pistell and Blackman. It also failed to disclose that Pistell was in severe financial trouble and owed the United States government more than $500,000 in back taxes and that the United States government had imposed a lien on Pistell's property. The memorandum made no disclosure that a substantial portion of the money invested by IIT in Vencap would be used to secure a $590,000 loan by Intercapital to Pistell personally, for the personal benefit of Pistell, i.e., to pay his back taxes owed to the United States government, and the fact that much of the cash transferred to Vencap by IIT would be turned over to companies in which Pistell had a substantial personal interest.
>
> "There is evidence that Pistell has utilized the assets of IIT for his own personal benefit and has, through an excessive salary and compensation agreement in addition to gross expenditures, wasted the assets of IIT. . . ."* (963A)

This Court's discussion of theory (4) shows clearly that it overlooked the above-quoted portion of Judge Stewart's findings. Theory (4) is based upon the misleading nature of the statement in the three-page memorandum that Vencap would be operated solely as a bona fide enterprise whereas in fact it was intended to be used in substantial part for Pistell's benefit (Sl. Op., p. 3210).

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* The District Court went on to state that there is also an allegation by plaintiffs that the investment by IIT was part of a conspiracy to siphon money from IIT into the hands of Pistell, Vesco, LeBlanc, Meissner and Graze, but that ". . . there is insufficient evidence in the record as to those allegations to have them serve as a basis for the issuance of a preliminary injunction." (963A-964A)

This Court stated (Sl. Op., p. 3211):

> ". . . as we read the [district] court's opinion, it concluded there was the same lack of sufficient evidence to support this theory as for the conspiracy theory."

If this Court had considered the finding of Judge Stewart that the three-page memorandum made no disclosure of the fact that a large part of the proceeds of the investment would be diverted to Pistell's benefit and that this omission was "substantial and material" it would not have written the quoted sentence.*

Judge Stewart's findings in connection with theory (4) are not only exceedingly strong on the merits, but more importantly, they substantially satisfy the requirement adopted by this Court that, under the "activity within the United States" test of subject matter jurisdiction, the United States must be the situs of ". . . the perpetration of fraudulent acts themselves" (Sl. Op., p. 3220). Once the District Court found that the omission of any mention of Pistell's intentions was substantial and material, then it follows without the need for further elaboration that the actual diversion of the proceeds of the investment by Pistell, a substantial part of which was carried out in the United States, was an integral part of his fraudulent course of conduct. This Court stated (Sl. Op., p. 3221):

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* This Court also observed in connection with its discussion of theory (4) that Pistell ". . . testified that Graze knew about his tax problems before IIT invested in Vencap and that he told Graze about the loan before making it. The district court made no findings on this subject" (Sl. Op., p. 3211). While it is true that the District Court did not explicitly reject Pistell's testimony, such a rejection is necessarily implied by the District Court's conclusion that the omission of any mention of Pistell's intentions was material and substantial.

"And even on theory (4), while such acts might be viewed as merely evidencing Pistell's fraudulent intention when he induced IIT's investment, we see no reason why they could not also be regarded substantively as the acts that consummated the fraud. Even if at the time of the closing Pistell intended to use part of IIT's $3,000,000 investment in Vencap for his personal benefit, IIT could hardly have sued for the misrepresentation at that time. The subsequent acts would not only be evidence of the misrepresentation but the cause of the damage.

"The difficulty is that while there was an abundance of American activity, we cannot tell whether the district judge considered it to be within Rule 10b-5 or whether it was. Here again, with respect to theories (4) and (5), we need further findings as to the wickedness of particular transactions and as to whether they were engineered from the United States."

The inability of this Court to determine what activity Judge Stewart considered to be within Rule 10b-5 arises, in connection with theory (4), from the fact that this Court had overlooked Judge Stewart's finding of material omissions. Given this finding, the "wickedness" of Pistell's actual looting is obvious, even if this Court continues to find ambiguity in Judge Stewart's conclusions.

Conclusion

For the foregoing reasons, Plaintiffs respectfully request that this Court grant a rehearing and suggest that such rehearing be held in banc.

Dated: New York, New York
May 12, 1975

Respectfully submitted,

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Service of 2 copies of this within
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